

# Corporate Audit Mechanisms and Financial Reporting Quality of Listed Consumer Goods Manufacturing Companies in Nigeria

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## Abstract

The study investigated the relationship between corporate audit mechanisms and financial reporting quality of listed consumer goods manufacturing companies in Nigeria. The study utilized a sample of thirteen listed manufacturing companies in the consumer goods sector for a period of seven years (2012-2018). The Ordinary Least Square multiple regression technique was employed in the analysis of a pool of panel data obtained from the published annual reports of the sampled firms. The study found that external audit attribute (audit fee) and audit committee attribute (membership tenure) have significant relationship with financial reporting quality (earnings management, reporting timeliness, accounting conservatism and value relevance) of the sampled firms at 95% confidence level. The implication is that variation in reporting quality is significantly predicted by the audit mechanisms. The study concludes that corporate audit mechanisms (audit fee and audit committee tenure) have significant impact on the financial reporting quality of listed consumer goods manufacturing companies in Nigeria. Based on the findings, it was recommended among others, that compensation for external auditors should include upward review of the audit fee annually and the provision of necessary resources both financial and otherwise to enhance quality financial reporting.

**Keywords:** Audit, Corporate Audit Mechanism, Financial reporting Quality, Audit committee

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## 1. Introduction

Today, by legal and standard requirements, companies are expected to have audit committees, external and internal auditors as required by the Companies and Allied Matters Acts (CAMA, 1991) as amended, S.357. The existence and operation of the above required audit components which is what we describe as audit mechanisms. The audit mechanisms play a crucial role in helping to promote financial reporting quality. Existing literature on auditing and financial reporting quality hypothesize that auditors are determinants of earnings quality or financial reporting quality, because of their role in mitigating intentional and unintentional misstatements (Dechow, Ge, & Schrand, 2010).

The audit mechanisms serve a fundamental purpose in helping to enforce accountability and promote confidence in financial reporting. Relationships between principals and their agents are of particular importance in understanding how audits have evolved and continue to develop. The statutory audit has developed over at least a century in response to agency risks. Directors are delegated responsibility for managing the affairs of the company by the owners and financial report therefore became a primary mechanism for shareholders to hold the directors to account.

Many studies such as, Ashbaugh, LaFond, and Mayhew, (2003); DeAngelo, (1986) Dechow, Sloan and Sweeney, (1995); and Jones, (1991) etc, assessed the relationship between audit attributes and financial reporting quality. The studies are, however, based largely on US and European data. To the best of my knowledge, related studies in Nigeria have largely used primary data (obtained through the questionnaire) in their analysis. For instance, Kiabel (2012) investigated the relationship between internal auditing and performance of government enterprises in Nigeria and used primary data obtained through the questionnaire. The study found no strong association between internal auditing practices and financial performance of Government Owned Companies and that political influence does not significantly impact this relationship. Similarly, Nwanyanwu (2017) examined the influence of audit quality practices on financial reporting in Nigeria, drawing evidence from auditing firms, using basically primary data obtained through the questionnaire, found a statistically significant positive relationship between the measures of audit quality (auditor independence, technical training and proficiency and engagement performance) and financial reporting (measured in terms of reliability of financial report). A more recent study by Bala, Amran and Shaari (2018) investigated the relationship between audit fees and financial reporting quality, using Listed Companies in Nigeria. Although the data used in this case was secondary, they, however, concentrated on a variety of listed companies and measured financial reporting quality using only one proxy, the accrual model otherwise called earnings management. This study used 4 measures of financial reporting quality (earnings management, timeliness, conservatism and relevance), and secondary data from only listed manufacturing companies. Using 4 measures of financial reporting quality will provide a broader view of reporting quality.

Similarly, Umaru (2014) investigated the relationship between audit attributes (audit compensation, audit firm independence, audit firm type and joint audit) and financial reporting quality of listed building material firms in Nigeria. As a departure also, this work is focused on listed consumer goods manufacturing firms in Nigeria.

Generally, the studies cited above have used one of either external audit, internal audit or audit committee as proxies of corporate audit mechanisms, The present study, however, used external audit and audit committee as proxies of corporate audit mechanisms. While some studies cited above have examined the association between corporate audit and financial reporting quality, it appears similar studies in Nigeria have not measured financial reporting quality using earnings management, timeliness, value relevance and accounting conservatism in the consumer goods manufacturing sector. The present study fills this gap by examining the relationship between corporate audit mechanisms and financial reporting quality in Nigeria, working with post IFRS adoption data from listed consumer goods manufacturing firms.

One of the critical roles of audit mechanisms is that, they assure confidence to financial statements users about the reported information. Audit services have been critical to financial reporting quality since the industrial revolution (that is, separation of ownership from management). Research has shown that audit effort or effectiveness should be associated with improved financial reporting quality (Jeff, Gilad, & Stephen, 2014), which in turn should affect both the firm and the economy positively. However, audit failure has often led to the eventual collapse of firms of various sizes and even called to questions the integrity of auditors and characteristics of corporate audit mechanisms. Nigeria like other countries of the world witnessed corporate scandals and failures, such as Oceanic Bank, Societe Generale Bank, Savannah Bank and Cadbury Plc, as a result of financial reporting failure, in spite of the auditor's endorsement that the financial reports were true and fair, and conforms to the relevant rules and regulations; and reflects actual transactions.

Aside from the above negative impact at the firm level, the entire economy of the nation can also be affected negatively when the audit mechanisms and the resultant financial report fails. Poor financial reporting can inhibit investment, because investment normally flows in the direction of quality financial reporting. Investment in our economy is a challenge, partly because of poor financial reporting resulting from either failure or under-performance of business managers who manipulate

accounting numbers to satisfy their own interest instead of the interest of the owners. This manipulation is not supposed to go unchecked. The corporate audit mechanisms have the responsibility of "checking" and reporting to owners. The question now is, how effective are the audit mechanisms in providing this check in the manufacturing sector in Nigeria? Will they mitigate errors and manipulations and ensure the realization of the IFRS financial reporting fundamental qualitative characteristics of faithful representation and relevance and other enhancing qualities?

Accordingly, this study is motivated by the critical role that the audit components have in corporate financial reporting with the understanding that accounting irregularities and misstatements including earnings management will impair financial reporting quality and threaten the "going concern" of corporate entities. Therefore, it is imperative to evaluate this role from different perspectives and sectors of the economy. This study established the relationship audit mechanisms have with financial reporting quality using data from manufacturing firms (Consumer goods sector) listed on the Nigerian stock exchange. While some studies have examined the association between corporate audit and financial reporting quality, similar studies in Nigeria have not been undertaken in the consumer goods manufacturing sector.

#### *Research Hypotheses*

In line with the objectives of this study, the following hypotheses were formulated in null form;

H<sub>01</sub>: External audit has no significant relationship with the earnings management of quoted manufacturing companies in Nigeria.

H<sub>02</sub>: There is no significant relationship between external audit and the timeliness of financial report of quoted manufacturing firms in Nigeria.

## **2. Literature Review**

Extant empirical literature on the relationship between external audit quality and financial reporting quality from different part of the world provide mixed results. Although the studies used different methodologies in different environment, this study is designed to provide evidence from Nigeria. The extent of the audit fee is basically elucidated by client attributes related to audit effort and audit risk (Turpen, 1995).

Previous studies document that higher audit fees are related to lesser earnings management and higher financial reporting quality. For instance, Franke, Johnson and Nelson (2002) studied the effect of audit fees and earnings management in United States of America. The study reveals that audit fees have a negative significant relationship with earnings management. This is affirmed by Hoitash, Markelevich and Barragato (2007) who applied 13,860 firm-year observations and determine the influence of audit fees and audit quality in US. Their finding reveals a negative significant correlation between audit fees and discretionary accruals. Mitra, Deis and Hossain (2009) examined the relationship between audit fees and FRQ of Big 5 client firms in United States of

America. They employed a sample of 6,852 firm-year observations for the period of 2000 to 2005. Their finding reveals that audit fees reduce the likelihood of abnormal accruals and thus increase earnings quality. More so, Carmona, Momparler and Lassala (2015) explored the relationship between audit fees and audit quality of listed firms in Spain. They showed that audit fees are negatively and significantly related to discretionary accruals. This indicates that higher audit price is related to lower discretionary accruals and higher financial reporting quality.

Moreover, Francis and Ke, (2003); Reynolds and Francis, (2000) found that audit fee does have a negative relationship with earnings quality, and thus improve the quality of financial reporting. On the other hand, Gul *et al.*, (2003) examined the relationship between audit fees and discretionary accruals in a sample of Australian firms, their results showed a positive association between financial reporting quality (discretionary accruals) and audit fees. They dispute the belief that audit fees erode independence. The debate in the literature on the effects of the various components of auditor's compensation on auditor independence has produced mixed results. Some arguments like Simunic (1984) and Francis *et al.*, (2003) supported the notion of a positive association between auditor independence and compensation. On the other hand, financial dependence of the audit firm on a client may also increase the likelihood that the auditor will succumb to management's requests leading to lower quality financial statements (Espinosa – Pike & Barrainkua, 2016).

Simunic (1984) modeled the joint demand for both audit and non-audit services. He demonstrated that when the auditor provides both services a cost savings (due to "knowledge spillovers") from the joint supply of these services occurs. As a result, when the same auditor provides both services, the cost savings may benefit the accounting firm. The auditor, now earning rents, faces a higher marginal expected loss from being dismissed by top management producing a greater incentive for the auditor to conceal bad news or comply with management. DeAngelo (1981) conceded that increased revenues generated by auditors from consulting fees may create an incentive for auditors to compromise their independence and report favorably in order to retain clients. However, when auditors have more than one client there is less financial dependence on a single client. Reputational penalties constrain the behavior of audit firms because the gains from acquiescing to any one client's demands are outweighed by the reputational losses that would be imposed by other clients who need and value the audit firms with a reputation for independence.

Moreover, in the United States of America, Brown *et al.*, (2006) studied the influence of auditor independence on earnings quality using audit fee and non-audit fee; their findings show a positive association between auditor independence and earnings quality, signifying auditor independence improves the quality of earnings. They conclude that auditor independence does not, by itself, materially degrade the quality of financial disclosures (either internally or externally). However, Hribar *et al.*, (2010) found evidence of positive association between unexplained audit fees and low earnings quality, from a sample of United State firm. They conclude that auditors increase audit hours and audit fees in cases where they perceived client's accounting quality to be poor and this improves accounting quality. On the other hand, Basioudis *et al.*, (2006) found that firms with high audit fees are more likely to receive a going concern modified audit opinion whereas firms with non-audit fees are less likely to receive going concern modified opinion in a small sample of financially distressed United Kingdom firms, an indication that, non-audit fees impair independence.

In Nigeria, Semiu and Kehinde (2011) studied the perception of auditor independence in Nigeria during the period of 2000 to 2008; their results showed that the size of audit fee is the most influencing factor capable of deterring auditor independence in Nigeria.

In a similar study, Felix (2015) confirmed that audit and /or non-audit fees threaten auditors' independence in Nigeria. In contrast, Umar (2012) investigated the stakeholders' perception of non-audit services provision via auditor independence in Nigeria during the period 2005 to 2010, his findings reveal that non-audit services do not impair auditors independence. However, the findings reveal that there are a number of threats to auditor independence and one of which is familiarity, which comes as a results of long-term audit firm-client relationship.

The Clients of large audit firms have been shown to have higher accrual quality, typically measured as lower absolute values of discretionary accruals (Becker, DeFond, Jiambalvo, & Subramanyam, 1998; and Francis, Maydew and Sparks 1999), and are less likely to manage earnings, as evidenced by income increasing accruals, small positive earnings changes, or meeting/beating analyst expectations (Becker, DeFond, Jiambalvo, & Subramanyam, 1998). In addition, the stock market response to an earnings surprise is greater (Teoh & Wong, 1993) and analyst forecasts are, on average, more accurate for clients of large audit firms (Behn, Choi & Kang, 2008) suggesting that higher audit quality contributes to more informative earnings disclosures and better informed analysts.

Prior research has shown that audit quality is positively associated with audit firm size (e.g., Krishnan & Schauer, 2000; Lennox, 1999; Colbert & Murray, 1998). However, there is other evidence showing that size may not always be positively related to audit quality and that the largest accounting firms may not always provide higher quality audits than do small accounting firms (e.g., Tate, 2001; Lam & Chang, 1994). For example, using discretionary accruals as the measure for earnings management, Becker *et al.* (1998) found that audit quality is negatively related to income-increasing discretionary accruals, which indicates that high audit quality is associated

with low information asymmetry. Teoh and Wong (1993) found that clients of large audit firms are associated with higher earnings response coefficients (ERCs), that is, the coefficient on earnings resulting from regressing stock returns on reported earnings. It measures the extent to which the market responds to earnings. Teoh and Wong (1993) indicated that the ERC of companies audited by large accounting firms is higher than that of companies audited by small accounting firms. Since the ERC reflects the perception of audit quality by financial statement users, it measures perceived audit quality.

Some Scholars have argued that the quality of an external auditor is an important factor affecting financial reporting quality, whereby a high quality external auditor is expected to have an influence on the quality of financial reporting. Given the existence of information asymmetries and the potential conflicts of interest between company management and outside users of financial information, an audit of financial reports by third party can enhance the quality of the financial information reported by management because a high quality auditor is more likely to detect questionable accounting practices and to a certain extent may compel management to follow accounting practices as prescribed by the accounting standards (Rahman & Ali, 2006). However, prior studies have failed to prove this contention. By using a proxy of brand name auditor as provider of higher quality audit, Davidson, *et al* (2005) did not find any significant relationship with the level of discretionary accruals and Alsaed (2006) did not find any significant relationship with the level of voluntary disclosures.

### 3. Methodology

This study adopts correlational and Ex-post facto research design to investigate the relationships between corporate audit mechanisms and the financial reporting quality of quoted manufacturing firms (Consumer goods sector) in Nigeria. The population of the study consists of the 21 quoted manufacturing firms (Consumer goods sector) operating on the Nigerian Stock Exchange (NSE) between 2012 to 2018. (NSE, 2018). The choice of the study period range (2012 – 2018) is because it represents the post International Financial Reporting Standards (IFRS) adoption period. The sample used is 13 manufacturing companies (Consumer goods sector) quoted on the Nigerian stock exchange

### 4. Results

**Table 1: Correlation Matrix of the Variables**

Covariance Analysis: Ordinary

Sample: 2012-2018

Included observations: 91

Correlation Probability Observations	EMGT	TIME	VAL	CONS	EAA	ACA	LEV	SIZE
EMGT	1.000000 ----- 91							
TIME	-0.658935 0.0000 91	1.000000 ----- 91						
VAL	-0.365643 0.0004 91	0.542528 0.0000 91	1.000000 ----- 91					
CONS	-0.150872 0.1534 91	0.122383 0.2478 91	0.073989 0.4858 91	1.000000 ----- 91				
EAA	0.297508 0.0042 91	0.380013 0.0002 91	0.175539 0.0960 91	0.051689 0.6265 91	1.000000 ----- 91			
ACA	0.535689 0.0000 91	-0.312913 0.0025 91	-0.006850 0.9486 91	-0.092639 0.3825 91	0.578680 0.0000 91	1.000000 ----- 91		
LEV	0.412162 0.0000 91	0.276974 0.0079 91	-0.122230 0.2484 91	0.006526 0.9510 91	0.941057 0.0000 91	0.517090 0.0000 91	1.000000 ----- 91	
SIZE	-0.382802 0.0002 91	-0.363040 0.0004 91	-0.229670 0.0285 91	0.024302 0.8191 91	-0.958106 0.0000 91	-0.601974 0.0000 91	-0.915783 0.0000 91	1.000000 ----- 91

The matrix in the table above shows the correlation coefficient, probability and the data points used to estimate the parameters for each pair of variables.

**Table 2: Correlation Matrix of External Audit Attribute and Financial Reporting Quality**

Covariance Analysis: Ordinary

Sample: 2012-2018

Included observations: 91

Correlation Probability Observations	EMGT	TIME	VAL	CONS	EAA
EMGT	1.000000 ----- 91				
TIME	-0.658935 0.0000 91	1.000000 ----- 91			
VAL	-0.365643 0.0004 91	0.542528 0.0000 91	1.000000 ----- 91		
CONS	-0.150872 0.1534 91	0.122383 0.2478 91	0.073989 0.4858 91	1.000000 ----- 91	
EAA	0.297508 0.0042 91	0.380013 0.0002 91	0.175539 0.0960 91	0.051689 0.6265 91	1.000000 ----- 91

The table above provides answers to the first 4 research questions; the relationship between external audit and the measures of financial reporting quality (earnings management, timeliness, value relevance and conservatism)

External audit fee is positively correlated with all the measures of financial reporting quality. For earnings management, the correlation coefficient is 0.297508. The strength of the relationship is significant. The implication is that as audit fee increases, discretionary accruals will increase significantly for the sampled firms. This negates the expectation of increased audit fee decreasing the occurrence of earnings management. The relationship between audit fee and timeliness is very significant and positive as shown by the coefficient of 0.380013. The implication is that as audit fee increases, reporting timeline also increases. Audit fee is also positively correlated with value relevance at a coefficient of 0.175539, however the strength of the relationship is insignificant as indicated by the probability value of 0.0960, which is greater than the threshold of 5%. Lastly, the relationship between audit fee and conservatism is insignificantly positive at a probability of 0.6265. The implication is that as audit fee increases, conservative accounting increases insignificantly.

#### *Discussion of Findings*

It is generally accepted that audit effort or effectiveness should be associated with improved financial reporting quality (Jeff, Gilad, & Stephen, 2014), which in turn should affect both the firm and the economy positively. Lee *et al.* (2006) stated that, there is an assumption that the quality of financial statement data is a joint function of management representations and the audit process. It has been suggested that the contents of annual reports are not only audited but also influenced by the audit functions (Wallace *et al.*, 1994). Audit quality should be associated with high information quality of financial statements because financial statements audited by high quality auditors should be less likely to contain material misstatements. From the tests conducted on the sampled data collected and the analyses of the results, this study found that corporate audit mechanisms (external audit and audit committee) are strongly associated with financial reporting quality in the listed consumer goods manufacturing companies in Nigeria. Evidences from the multiple regression results indicated that the proxies of corporate audit mechanisms (external audit and audit committee) jointly explained about 49%, 68.5%, 87% and 96% of the variation in earnings management, reporting timeliness, conservatism and value relevance respectively, of listed consumer goods manufacturing companies in Nigeria at 95% confidence level during the period covered by the study. Specifically, the study showed (multivariate analysis) that there is a negative and significant relationship between external audit attribute (audit fee) and earnings management (discretionary accruals). This means that increment in audit fee will reduce the occurrence of earnings management. The extent of the audit fee is basically explained by client attributes related to audit effort and audit risk (Turpen, 1995).

Previous studies indicated that higher audit fees are related to lesser earnings management and higher financial reporting quality. For instance, Franke, Johnson and Nelson (2002) studied the effect of audit fees and



earnings management in US. The study reveals that audit fees have a negative significant relationship with earnings management. This is supported by Francis and Ke, (2003); Reynolds & Francis, (2000); Umaru (2014), Bala, *et al.*, (2018) who found that audit fee does have a negative relationship with earnings management (discretionary accruals), and thus improve the quality of financial reporting. However, it contradicts the findings of Gul *et al.*, (2003) who examined the relationship between audit fees and discretionary accruals in a sample of Australian firms, their results showed a positive association between financial reporting quality (discretionary accruals) and audit fees.

External audit attribute is significantly and positively associated with reporting timeliness. The implication is that the more fees auditors receive the longer the reporting time. In other words, audit fee have no role in improving reporting timeliness. This result contradict the normal expectation that higher audit fee will produce more quality and timely report. The finding is in sharp contrast to that found by Behrouzi, *et al.*, (2013). The results of their multiple regression analysis revealed that audit fees have an inverse relationship with timeliness of accounting information. In other words, as audit fees increase, financial statements are provided more timely for its users. External audit fee has a significant positive relationship with accounting conservatism. This implies that increased audit fee will increase the level of conservative accounting. If audit fee is related to work done, then more audit fee implies extensive audit work. The result of extensive audit work is the elimination of error and misstatement, and the enthronement of conservatism in the reporting process.

It is generally believed that conservatism can lessen litigation risk, reduce opportunist motives for managers when disclosing results, (that is diminish earnings management), increase contract control, thereby resulting into more reliable accounting numbers (Watts 2003; Ball & Shivakumar, 2005). The need for accounting conservatism is related to the increase of the demand for the credibility in accounting information (Hellman, 2008). The need for conservatism is linked with the Agency Theory (Basu, 1997) to solve the problem that might emerge between managers and stockholders. Prior research argues that accounting conservatism acts as a governance mechanism that reduces substandard reporting. Contrary to our finding, Hamdan, *et al.*, (2012), found that the amount of auditing fees have no role in improving accounting conservatism in financial statements. External audit fee is positively and significantly associated with relevance of accounting information. This means that audit quality, measured by higher audit fee will result into more relevant accounting numbers. Earnings, equity and any other accounting items included in the income statement and statement of financial position, are all recognized as accounting information or accounting measures. However, the question is how and to what extent these accounting measures are important. When accounting information provides its manifestation unswervingly in market prices and investors' decisions, then it is said that the information given in the financial statements is of high quality and it is deemed suitable to be acknowledged as value relevant. Our finding showed that increased audit fee will improve the predictive power of accounting measures.

## 5. Conclusion and Recommendations

The study provides empirical and statistical evidence on the relationship between corporate audit mechanisms (external audit and audit committee) and financial reporting quality (earnings management, reporting timeliness, accounting conservatism and value relevance) of listed consumer goods manufacturing companies in Nigeria. The study concludes that audit fee and Audit Committee tenure have significant impact on the financial reporting quality. Specifically, an increment in audit fee has potential to make external auditors mitigate earnings management, increase the extent of audit work, which could adversely affect reporting timeliness, increase conservative accounting practices, and also increase the relevance of accounting numbers in client firms. It goes to confirm the important role external auditors have in producing quality financial reports when audit fee is increased. In line with the findings of the study, the following recommendations are made:

- External auditors should be adequately compensated to enable them reduce the occurrence of earnings management and other misstatement. Adequate compensation may be relative but should include the provision of necessary resources both financial and otherwise. In addition, if the auditor is retained beyond one tenure, the audit fee should be reviewed upward annually and paid on time.
- Auditors should endeavour to conclude their audit and write their report on time to enhance relevance of the report content to users. Audit committee should also ensure that external auditors deliver their report on time. Timely information improves the relevance of that information.

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